Office of Chief Counsel
Internal Revenue Service
memorandum

CC:LM:MCT:PHI:TL-N-75-01
JRGilbert

date:

to: Francis J. Koneski, Case Manager, Group 1542
(King of Prussia P.O.D.)

from: Associate Area Counsel (LM:MCT) - Philadelphia

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subject: [redacted] - **Section 195 Elections Pertaining to** [redacted] **Acquisition Costs**

DISCLOSURE STATEMENT

This memorandum constitutes return information subject to section 6103 of the Internal Revenue Code[1]. It contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. This advice may not be disclosed to taxpayers or their representatives.

DISCUSSION

Reference is made to the request of Team Coordinator Donald Cronauer for our review of his draft Form 886-A proposing to disallow amortization deductions claimed by [redacted] ("[redacted]") pursuant to § 195 on its consolidated Forms 1120 for fiscal years ending [redacted] ("FYE [redacted]") and subsequent.

ISSUE

Whether [redacted] and its consolidated subsidiary [redacted] ("[redacted]") are entitled to claim amortization deductions from elections pursuant to § 195 to capitalize costs emanating from [redacted]'s acquisition of [redacted].

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[1] Except as otherwise noted, all references are to the Internal Revenue Code of 1986, as amended.

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CONCLUSION

While we believe that an adjustment is warranted to disallow the § 195 election made by [redacted] on the consolidated return for FYE [redacted], we cannot determine if an adjustment is warranted for § 195 election made by [redacted] due to insufficient information. Our recommendations of additional information to request from [redacted] are described in detail below.

FACTS

[redacted] is [redacted] chains in the United States. According to [redacted]'s annual report for FYE [redacted] it was then operating over [redacted] [redacted] in [redacted] eastern and western states and the District of Columbia. Before being acquired by [redacted], [redacted] (a publicly traded corporation) was the [redacted] retailer in the western United States.

On [redacted], [redacted]'s Board of Directors approved a prospective acquisition of [redacted]. On [redacted], [redacted]'s Board of Directors approved the transaction, and the two companies executed a merger agreement[2] on [redacted]. On [redacted], [redacted] acquired [redacted] in a stock-for-stock exchange, pursuant to the merger agreement.

You indicate in the draft Form 886-A that [redacted] first expressed interest (through its agents) in [redacted] on [redacted]. [redacted] filed a Form S-4 (Registration Statement) with the Securities and Exchange Commission ("SEC") on [redacted] which described the proposed acquisition of [redacted].[3] This document states that on [redacted], [redacted] and [redacted] entered into a [redacted] Agreement. We are not aware of the terms of this agreement. Since your Form 886-A makes no mention of it, we presume that you have not been provided with a copy of the agreement.

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[2] We note a discrepancy between the merger agreement (which states that [redacted] will merge into [redacted], with [redacted] as the surviving corporation in the merger) and the position taken by [redacted] with regard to the transaction on the FYE [redacted] Form 1120 (namely, that the transaction was a "[redacted] reorganization, with [redacted] surviving as a consolidated subsidiary of [redacted]. Since the FYE [redacted] and subsequent returns indicate that [redacted] did in fact survive as a subsidiary, we assume for purposes of this advisory that [redacted] and [redacted] subsequently modified the merger agreement.

[3] We obtained a copy of this document on the Internet from the SEC's Edgar database.

You indicate in the draft Form 886-A that on [redacted], the chief executive officers of [redacted] and [redacted] met along with their advisors to discuss a possible business combination. The Form S-4 filed with the SEC indicates on page [redacted] that the CEO's met at least three more times, on [redacted] and [redacted], to discuss the terms of [redacted]'s acquisition proposals.

[redacted] engaged the investment banking firm of [redacted], [redacted] ("[redacted]") to act as its exclusive financial advisor with respect to the acquisition of a company known by the code name "[redacted]" or "[redacted]" which we presume to be [redacted]. A letter from [redacted] dated [redacted] described the services which it rendered in this matter[4] and the compensation which it was to be paid[5], but the letter does not indicate the period when the services were rendered. Since your Form 886-A makes no mention of an engagement letter from [redacted] or a contract between [redacted] and [redacted], we presume that you have not been provided with copies of these documents.

[redacted] engaged the investment banking firm of [redacted] ("[redacted]") to act as its financial advisor in connection with a proposed strategic transaction with [redacted]. In exchange for a transaction fee of $[redacted] payable upon consummation, [redacted] agreed to perform valuation analyses, coordinate visits by [redacted] and assist in negotiating the financial aspects of the transaction. A letter from [redacted] dated [redacted] described [redacted]'s compensation and the services rendered in this matter, but the letter does not indicate the period when the services were rendered. Again, since your Form 886-A makes no mention of an engagement letter from [redacted] or a contract between [redacted] and [redacted]

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[4] The services included:

a) Assist in evaluating the [redacted], its operations, its historical performance and its future prospects;
b) Advise on a proposed purchase price and form of consideration;
c) Assist in structuring the transaction;
d) Negotiate the financial aspects on any transactions; and
e) Deliver an opinion to the Board of Directors as to the fairness from a financial point of view of the consideration to be paid.

[5] [redacted]'s fees included a retainer of $[redacted] upon execution of the agreement, an opinion fee of $[redacted], both of which would be credited against [redacted]'s transaction fee of $[redacted] payable by [redacted] if the transaction was consummated. You indicate that [redacted] capitalized $[redacted] of fees to [redacted] in its section 195 election; you did not indicate how [redacted] treated the remaining $[redacted] of the [redacted] fee for federal tax purposes.

[redacted], we presume that you have not been provided with copies of these documents.

Prior to its acquisition by [redacted], [redacted] was an accrual-basis taxpayer which filed its annual federal income tax returns using a fiscal year-end of [redacted]. [redacted]'s final Form 1120 as a parent corporation covered the short period from [redacted] through [redacted]. For its taxable period from [redacted] through [redacted], [redacted] consented to be included as a subsidiary in the consolidated Form 1120 filed by [redacted].

On its Form 1120 for FYE [redacted], [redacted] elected under § 195 to amortize over a period of [redacted] months the following costs related to its acquisition of [redacted]:

VENDOR	DESCRIPTION	AMOUNT
[redacted]	[redacted]	$[redacted] [6]
	Total	$[redacted]

For the following year ended [redacted], [redacted] amended its election under § 195 to increase its [redacted] acquisition costs to be amortized by $[redacted], bringing its total § 195 costs to $[redacted]. You did not identify the payees of these additional costs, nor indicate their nature.

On the consolidated [redacted] Form 1120 for FYE [redacted], [redacted] elected under § 195 to amortize over a period of [redacted] months the following costs related to its acquisition by [redacted]

VENDOR	DESCRIPTION	AMOUNT
[redacted]	[redacted] [7]	

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[6] Without providing any documentary support such as an invoice from [redacted], [redacted] alleged that the amortized [redacted] fees were incurred for investigatory work from [redacted] through early [redacted].

[7] The total fees charged by [redacted] were $[redacted]; you indicate in your Form 886-A that [redacted] elected under § 195 to amortize [redacted]% of these fees, based upon a representation from [redacted] that approximately [redacted]% of its charges were incurred prior to the time [redacted]'s Board of Directors voted to approve the merger. You do not indicate how [redacted] treated the remaining [redacted]% of the [redacted] fee for federal tax purposes.

LAW

Section 195(a) provides that except as otherwise provided therein, no deduction is allowed for start-up expenditures. Under § 195(b), start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses are allowed as a deduction prorated equally over a period of not less than 60 months (beginning in the month the active trade or business begins).

Section 195(c)(1) defines "start-up expenditure," in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred. Start-up expenditures, however, do not include any amounts that may be deducted under §§ 163(a), 164, or 174 .

Sections 162 and 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. See Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345 (1971).

Under § 263, costs of acquiring property having a useful life substantially beyond the taxable year must be capitalized. Some general examples of capital expenditures are provided in Treas. Reg. § 1.263(a)-2(a) and include costs of acquisition of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Under this general regulatory provision, courts have long held that "legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of such property are capital expenditures." Woodward v. Commissioner, 397 U.S. 572 (1970)).

In Ellis Banking Corp. v. Commissioner, T.C. Memo, 1981-123, aff'd in part & rem'd in part, 688 F.2d 1376 (11th Cir. 1982), the taxpayer incurred expenses for office supplies, filing fees, travel, and accounting services in connection with its examination of target's books and records. The examination was performed pursuant to an acquisition agreement for the purchase of target's stock that was contingent on several terms and conditions, such as regulatory approval. The Tax Court concluded that the expenses were nondeductible capital expenditures incurred in the acquisition of a capital asset. The Court of Appeals for the Eleventh Circuit substantially affirmed, noting that the requirement that costs be capitalized extends beyond the price payable to include any costs incurred by the buyer in connection with the purchase, such as appraisals of the property or the costs of meeting any conditions of sale.

Rev. Rul. 77-254, 1977-2 C.B. 63 considers which costs incurred in the potential acquisition of a new business are capital acquisition costs for purposes of §§ 165 and 263. That ruling, which is specifically referenced by the legislative history of § 195 (See H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980) ("House Report"); S. Rep. No. 1036, 96th Cong., 2d Sess 10 (1980) ("Senate Report")), provides that expenses incurred in the course of a general search for, or an investigation of, a business that relate to the decisions whether to purchase a business and which business to purchase are investigatory costs. Once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature.

In Rev. Rul. 99-23, 1999-1 C.B. 998, the Service ruled that: (1) expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine whether to enter a new business and which new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation) qualify as investigatory costs that are eligible for amortization as start-up expenditures under § 195; (2) expenditures incurred in the attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs under § 263; and (3) the nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the whether and which decisions, or an acquisition cost incurred to facilitate consummation of an acquisition.

In Indopco v. Commissioner, 503 U.S. 79 (1992), the United States Supreme Court held that transaction costs incurred in connection with a friendly takeover by another corporation should be capitalized. Such costs included fees paid to investment bankers and attorneys, as well as other miscellaneous expenses. The Court found that the taxpayer was unable to demonstrate that the transaction costs were deductible and held that such costs, which provided a significant future benefit to the taxpayer, should be capitalized.

In Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000), the taxpayer incurred expenses for legal fees for investigatory and due diligence related services in regard to a merger, and also incurred internal costs (officer salaries) related to various aspects of the transaction. The Eighth Circuit reversed the Tax Court's finding that all of these expenses were capital expenditures under § 263, and it allowed the taxpayer to deduct all of the internal costs[8], plus the legal fees incurred prior to the taxpayer's decision to be acquired. While the Eighth Circuit was careful not to establish a bright-line rule for determining the final decision date, it found that the decision was final as of the date the taxpayer and its merger partner entered into the Agreement and Plan of Reorganization.

ANALYSIS

While [redacted] and [redacted] both made elections under § 195 for costs arising out of the same transaction, it is necessary to discuss the propriety of their respective elections separately, due to the inherent differences between being the acquirer versus the target.

A. Section 195 Amortization versus Section 263 Capitalization - [redacted]

As a preliminary matter, we assume that by virtue of having made the § 195 election with regard to the [redacted] acquisition costs, [redacted] concedes that the acquisition constitutes a new trade or business, and not an expansion of its existing business.[9] We have not been asked to render an opinion as to whether the [redacted] acquisition constitutes a new trade or business for [redacted], versus an expansion of its existing business, and we do not do so.

Expenditures eligible for amortization pursuant to § 195 must satisfy two requirements. First, the expenditures must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer. Second, the expenditure involved must be one which would be allowable as a deduction for the taxable year in which it is

[8] The internal costs were found to be only indirectly related to any long term benefit from the transaction, and they therefore were deductible.

[9] This distinction is significant because investigatory costs in the case of an expansion are deductible pursuant to § 162, while such costs in the case of acquiring a new trade or business are capitalized and amortized (subject to § 263) pursuant to § 195.

paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.

If an expenditure is not deductible because it would be a capital expenditure if incurred in the operation of an existing trade or business, the expenditure does not qualify for amortization under § 195. That is, § 195 does not override § 263. Thus, the expenditure must be an ordinary expense under § 162, and not a capital expenditure, to be a start-up expenditure under § 195. "Section 195 did not create a new class of deductible expenditures for existing businesses. . . In order to qualify under § 195(c)(1)(B), an expenditure must be one that would have been allowable as a deduction by an existing trade or business when it was paid or incurred." FMR Corp. v. Commissioner, 110 T.C. No. 30 (June 18, 1998).

Rev. Ruls. 77-254 and 99-23 hold that only those expenditures incurred in the course of a general search for or preliminary investigation of a business, that is, investigatory expenditures incurred in order to determine whether to enter into a transaction and which transaction to enter, may be amortized under § 195. Once a taxpayer has made the "whether and which" determinations, all costs incurred in the attempt to acquire the business must be capitalized under § 263 as acquisition costs.

The key issue to be determined in this case, therefore, is when [redacted] made a final determination to acquire [redacted]. Investigatory expenditures incurred prior to this date are amortizable under § 195, but costs incurred after this date must be capitalized.

The Team Coordinator takes the position in his Form 886-A that [redacted] made its final decision to acquire [redacted] prior to [redacted]. He argues that since [redacted] had identified [redacted] as an acquisition candidate by that date (the "which" question), it follows that [redacted] must have determined previously that it would complete the acquisition (the "whether" question).

Based upon its § 195 elections, [redacted] apparently takes the position that the final decision date was [redacted], the date the acquisition agreement was executed by [redacted] and [redacted]. We presume that [redacted] and [redacted] selected this date because it is when the parties were legally obligated to consummate the acquisition transaction.

We do not believe that either of these determinations of the "final decision" date are necessarily correct. The determination of whether a taxpayer's expenditures are incurred in the course of a general search or preliminary investigation, or in an attempt to acquire a specific business, will depend on all the facts and circumstances. See Wells Fargo & Co. v. Commissioner, 224 F.3d at 889. While it is possible that the decision date may have been made prior to [redacted], there simply is insufficient information available at this time for this determination to be definitively made. The Team Coordinator's position that the "whether" question by definition must have been made before the "which" question is not correct. It is entirely possible for [redacted] to identify [redacted] as a acquisition target before definitively deciding to complete the transaction.

It is also possible for [redacted] to have made the "final decision" to acquire [redacted] prior to executing the binding contract to do so. Nothing in the statute or legislative history suggests that the tax treatment of a prospective purchaser's investigatory costs is dependent upon the seller's commitment to the transaction. Congress explained that "[e]ligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business" (House Report at page 10, Senate report at page 11), but did not indicate that final means legally binding as to both the potential purchaser and seller.

We believe that the reference to a "final decision" describes the point at which a taxpayer makes its own decision whether to acquire a specific business, and subsequently incurs costs in an effort to consummate the acquisition. At that point the general and preliminary investigation ceases and the taxpayer initiates its acquisition process. Costs incurred in connection with this process must be capitalized. Whether a taxpayer is ultimately successful in its negotiations with a seller is not relevant to the determination of when the investigatory process ends and the acquisition process begins.

B. Information Gathering Recommendations - [redacted]

We are unable to determine when [redacted] made its decision to attempt to acquire [redacted], due to insufficient information. In order for this determination to be made, along with the determination of what costs should be amortized or capitalized, we recommend that you obtain the following information:

1. The [redacted] Agreement between [redacted] and [redacted];

2. All letters of intent[10] issued by [redacted] to [redacted];

3. All engagement letters from [redacted] and all contracts between [redacted] and [redacted];

4. Detailed invoices or other documentation describing the nature of the investment banking services rendered by [redacted] and the dates these services were rendered;

5. Verification of the federal tax treatment of the investment banker fees paid by [redacted] to [redacted] that were not part of [redacted]'s 9702 § 195 election;

6. Detailed invoices or other documentation describing the nature of legal and accounting services included in [redacted]'s FYE [redacted] § 195 election and the dates these services were rendered;

7. A schedule identifying the individual payees and amounts comprising the $[redacted] of additional § 195 costs elected by [redacted] to be amortized for the fiscal year ended February, [redacted] ("FYE [redacted]"); and

8. Detailed invoices or other documentation describing the nature of the additional § 195 costs included in [redacted]'s FYE [redacted] § 195 election, and the dates services were rendered, if applicable.

C. [redacted] § 195 Election - Determination of Proper Period

We do not believe that [redacted] is entitled to make any § 195 election on the FYE [redacted] consolidated return, and we recommend that you make an adjustment to disallow any resulting amortization deductions. By [redacted]'s own admission (see footnote 7), [redacted]% of the [redacted] fees were incurred prior to [redacted]. Accordingly, any § 195 elections for these fees should have been made on the [redacted] returns filed for the taxable periods ending [redacted] and [redacted]. Any [redacted] fees incurred after [redacted] would clearly be capital expenses pursuant to § 263, as the final decision was certainly made no later than this date.

[10] In Situation 3 of Rev. Rul. 99-23 and in Private Letter Ruling [redacted], the date of the issuance of a letter of intent by the taxpayer was found to be the final decision date.

We recommend that you inspect the [redacted] returns filed for the taxable periods ending [redacted] and [redacted] to determine if any § 195 elections were made for the fees paid to [redacted]. If the returns do not include § 195 elections, [redacted] will not be allowed at this time to make such an election, as § 195(d)(1) states that an election "shall be made not later than the time prescribed by law for filing the return ... (including extensions)."

On the other hand, if either return contains a § 195 election and you determine that you will commence an audit,[11] you should consider the criteria described above for [redacted] to determine the propriety of whether the costs are amortizable or whether they should be capitalized. We are unable to determine when [redacted] made its decision to allow itself to be acquired by [redacted], due to insufficient information. In order for this determination to be made, along with the determination of what costs should be amortized or capitalized, we recommend that you obtain the following information:

1. All engagement letters from [redacted] and all contracts between [redacted] and [redacted];

2. Detailed invoices or other documentation describing the nature of the investment banking services rendered by [redacted] and the dates these services were rendered; and

3. Verification of the federal tax treatment of the investment banker fees paid by [redacted] to [redacted] that were not part of the § 195 election.

D. Internal Costs

We note that your Form 886-A makes no reference to [redacted] or [redacted]'s internal costs (such as salaries) incurred for the acquisition. We recommend that you peruse the general ledgers or chart of accounts for the two corporations to see if they tracked their internal costs incurred for this or other merger and acquisition transactions. If you find that these costs were tracked, and the amounts involved are material, you should determine whether or not any of the costs should be capitalized. To make this determination, we recommend that you consider Rev. Rul. 73-580, 1973-2 C.B. 86, as well as the case law described above.

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[11] We understand that the examination of these returns is under the jurisdiction of your group, but that no examinations have commenced as of yet.

This concludes our advice and recommendation. Please feel free to call Attorney John R. Gilbert at 215-597-3442 with any additional questions you may have. We are available to discuss this matter further after you have obtained the necessary information. We are forwarding a copy of this memorandum to Division Counsel (LMSB) for mandatory 10 day post review. To assure that National Office has sufficient time to review our advice, we request that you refrain from issuing any Notices of Proposed Adjustment in this matter prior to [redacted].

JAMES C. FEE, JR.
Associate Area Counsel (LMSB)

cc: (via email only)
Division Counsel (LMSB) [TSS4510]
Harve Lewis, Senior Litigation Counsel (HQ) (CC:LM:MTC:SLC)